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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-3411

TULIA FEEDLOT, INC., *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit in this case.

OPINION BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at — F. 2d — and is reprinted in Appendix, *infra,* pp. 1a-11a.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was entered on June 2, 1975. (p. 1a*) The jurisdiction of this court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether fees Petitioner paid to its shareholders for guaranteeing its line of credit are deductible as ordinary and necessary business expenses that are reasonable in amount.

STATUTE INVOLVED

The statute involved is 26 U.S.C. § 162(a) of the Internal Revenue Code of 1954. (p. 20a).

STATEMENT OF THE CASE

Petitioner, Tulia Feedlot, Inc., brought this action for refund of Federal Income Taxes for the taxable year ended August 31, 1970.

Petitioner is a Texas corporation formed in 1962 for the purpose of feeding customers' cattle. The feeding of customers' cattle is not an unduly hazardous business in itself. It is the owners of the cattle who run substantial risk of loss due to declines in the market price of beef. (p. 15a).

Petitioner's feedlot capacity increased from 5,000 head of cattle in 1962 to 28,000 head of cattle in 1970. At various times since its inception, Petitioner, not having sufficient cattle in its pens to operate economically, purchased and fed cattle for itself. The pur-

* References to "a" are to the Appendix, *infra*.

chase of cattle and feed for such cattle required large amounts of cash. The usual method of financing the purchase of cattle is to put approximately thirty (30%) percent down and borrow the other seventy (70%) percent plus $100 per head for cost of feed. (pp. 12a and 13a).

The lending institutions would not make the loans unless they were secured not only by mortgages on the cattle and feed but also by the personal guarantees of the Petitioner's shareholders. For all practical purposes herein the Petitioner had twelve equal shareholders and each shareholder was a director. The guarantees given by Petitioner's shareholders prior to 1970 were $5,000 each in 1964, $8,000 each in 1965, and $45,000 each in 1968. In 1970 the guarantees were increased from $91,000 each in January, to secure a $1.1 million loan, to $125,000 each in March to secure a $1.5 million loan, to $150,000 each in July to secure a $1.8 million loan. (pp. 13a and 14a).

In 1968, Petitioner mortgaged its real and personal property to an insurance company for $350,000 loan. The insurance company required the shareholders to guarantee the loan pro rata. At the beginning and end of the fiscal year ending August 31, 1970 such loan balance was $340,000 and $320,000 respectively. (p. 14a).

On July 14, 1970, Petitioner's directors agreed to compensate themselves as shareholder-guarantors for lending their credit to Petitioner. It was decided that three (3%) percent of the $150,000 guaranty was to be paid to each shareholder for use of his credit. Accordingly, $4,500 was paid to each of twelve shareholder-

guarantors for a total of $54,000, which amount was deducted as an expense of doing business in the fiscal year ending in 1970. (pp. 13a-16a).

The Government disallowed the $54,000 deduction and assessed the resulting tax. Petitioner paid the assessment, filed a claim for refund which was disallowed, and timely brought suit for refund. (p. 13a).

In the subsequent trial of the case, the United States District Court found that the guarantor's fees paid by Petitioner to its shareholders were ordinary, necessary and reasonable business expenses. (pp. 12a-18a).

The Fifth Circuit reversed the District Court in a decision entered June 2, 1975, on the grounds that there was no evidence showing it was ordinary or necessary for cattle feedlots to charge fees for guarantees or that the fees paid were reasonable. (pp. 1a-11a).

REASON FOR GRANTING THE WRIT

In determining that the Petitioner failed to prove the deductions taken for fees paid to guarantors of its line of credit were ordinary, necessary and reasonable, the Court of Appeals for the Fifth Circuit made interpretations of "ordinary and necessary" and "reasonableness" that are in conflict with the decisions of this Court.

The undisputed facts show that there was a need for Petitioner to feed its own cattle in order to operate economically; that the purchase and feeding of its own cattle did produce large net gains overall; that Petitioner had to borrow large amounts of money to purchase and feed its own cattle; that the financial institutions required Petitioner's shareholders to personally guarantee the loans; that it was customary for financial institutions to require shareholders in the feedlot business to guarantee loans; that the financial

institutions would not have made the loans without the guarantees; that without the loans the Petitioner could not have successfully operated its business; that the ownership of cattle involved substantial risk of loss; that the guarantees of Petitioner's line of credit adversely affected the guarantors' personal credit and subjected them to substantial risk; that the shareholders over a period of years prior to the tax year guaranteed smaller loans without requirement of a fee but as the amount of the guarantee doubled and tripled in the tax year (in comparison with the largest amount guaranteed in prior years) the shareholders insisted on being compensated for such guarantees; and that the Petitioner's directors after much discussion concerning the shareholders' risk, the nature of Petitioner's operations, the prevailing interest rates and seeking outside advice to determine what a "proper guarantor's fee" would be, decided to pay 3% of the amount guaranteed as a guarantor's fee.

The Trial Court found upon the facts presented at the trial, that the guarantor's fees paid were deductible as ordinary and necessary expenses and were reasonable in amount. (pp. 12a-18a).

The Fifth Circuit reversed on the ground that the District Court's decision was clearly erroneous because Petitioner failed to prove the guarantors' fees were ordinary, necessary and reasonable in amount. (pp. 1a-11a).

Specifically, the crucial findings of the Fifth Circuit are as follows (pp. 8a-9a):

1. No evidence was presented to show that it was customary for a cattle feedlot's shareholders to charge a fee for their guarantees.

2. No evidence was presented to show what fees, given the risks involved, would be reasonable.

3. No evidence was presented as to the possibility and likely cost of obtaining these guarantees in an arm's length transaction in the market.

The crux of meeting the burden of proof required by the Fifth Circuit is that there be such proof in the first place. Insofar as all parties concerned with Petitioner's case knew, the fees paid Petitioner's shareholder-guarantors were the first ever to be paid in the cattle feedlot busines. There is no market place in West Texas, or anywhere else insofar as Petitioner knows, to obtain guarantees at arm's length for a closely held corporation in the risky[1] cattle feedlot business.

The precise issue of whether a new type of expense in a given industry is deductible has not been directly decided by this Court. Such issue presents an important question of federal law which has not been, but should be, settled by this Court.

In *Commissioner* v. *Tellier,* 383 U.S. 687, at 689, this Court held that the "origin and character of claims with respect to which the expense was incurred, . . ." is the basic test of whether the expense was a business expense. Further, the Court stated at 689 ". . . The principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those

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[1] The plight of ranchers and feedlots owning cattle on feed at the present time is common knowledge and the tremendous losses suffered in 1974 and 1975 in such businesses are documented in the Federal Bankruptcy records.

that are in the nature of capital expenditures, . . .". Again, in *Deputy* v. *duPont,* 308 U.S. 488 at 495, this Court held that the term "ordinary" requires that the transaction which gives rise to the expense must be of common or frequent occurrence in the type of business involved. Here the Fifth Circuit acknowledges Petitioner's evidence shows personal guarantees of the shareholders were commonly required in the feedlot business (p. 8a). The Circuit Court's requirement of evidence to show that it was customary for a cattle feedlot's shareholders to charge a fee for their guarantees goes beyond the burden required by this Court in *Commissioner* v. *Tellier, supra,* and *Deputy* v. *duPont, supra.*

Petitioner could not produce such evidence because insofar as it knew, at the time of the payment of the fees and at the time of the trial, it was the only feedlot whose shareholders charged a fee.

No case has been discovered that holds that a new expense resulting from a transaction that is common in a given business is not deductible simply because it had never been charged or deducted before.[2]

In the case of *Welch* v. *Helvering,* 290 U.S. 111 at 113, this Court stated that the fees paid therein "were

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[2] There is a dearth of cases concerning guarantees. The few cases concerning the matter are generally inconclusive and do not deal directly with the question of a new type of expense. See *A.A. & E.B. Jones Co.* v. *Commissioner,* 19 TCM 1561 (1960); *Central Asphalt Paving Co., Inc.* v. *Commissioner,* 37 P-H Tax Ct. Memo ¶ 68,225 (1968); *R. L. Heflin, Inc.* v. *U. S.,* 58 F.2d 482, (Ct. Cl. 1932), cert. den. 287 U.S. 631 (1932); *Long* v. *Commissioner,* 8 B.T.A. 737 (1927); *Monroe Sand & Gravel Co.* v. *Commissioner,* 36 B.T.A. 747 (1937); *Thornton, Davis B.* v. *Commissioner,* 14 P-H Tax Ct. Memo. ¶ 45,011 (1945); *Universal Milking Machine Co.* v. *Commissioner,* 4 B.T.A. 506 (1926).

necessary for the development of petitioner's business, at least, in the sense that they were appropriate and helpful." In this case there is ample evidence in the record that the fees were necessary because the financial institutions would not have lent the money without the guarantees; the shareholders would not have signed the guarantees without the fee; and without the loans, the feedlot business could not have been successfully carried on and developed.

To meet the Fifth Circuit's requirement of "reasonableness" Petitioner would have had to show comparable fees paid by other feedlots to their shareholders-guarantors, and also show the possibility and likely cost of obtaining such guarantees in an arm's length transaction in the market. Petitioner could not produce such evidence simply because insofar as it knew, at the time the fees were paid and at the time of the trial, it was the only feedlot paying guarantor's fees. Likewise, there is no market place in West Texas, or anywhere else, insofar as Petitioner knew, to obtain guarantees at arm's length for a closely held corporation in the risky cattle feedlot business.

The evidence does disclose that for several years prior to 1970 Petitioner's directors had discussed their guarantees in the light of the risk involved, current rates of interest, the nature of the business and the negative effect on their personal borrowing capacity. (pp. 14a-17a). The corporate minutes also reflect that the directors sought outside advice "concerning the proper guarantor's fees". The District Court found that the three (3%) percent fee charged was reasonable under the circumstances.

The Appellate Court erred in requiring a burden of proof that cannot be carried where a new type of expense is deducted. The burden placed on Petitioner by the Fifth Circuit is not required by any pertinent case dealing with the deductibility of business expenses coming within the terms "ordinary, necessary and reasonable" decided by this Court. See *Commissioner* v. *Tellier,* 383 U.S. 687, 16 L.ed 2d 185, 86 S.Ct. 1118 (1966); *Deputy* v. *duPont,* 308 U.S. 488, 84 L.ed. 416, 60 S.Ct. 363 (1940); *Lilly* v. *Commissioner,* 343 U.S. 90, 96 L.ed. 769, 27 S.Ct. 497 (1952); *Welch* v. *Helvering,* 290 U.S. 111, 78 L.ed. 212, 54 S.Ct. 8 (1933).

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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